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SUBJECT: Buffeted, Buffered, Challenged: The Economy of the Philippines in 2008-2009

REFS: a) Manila 2725, b) Manila 1050, c) Manila 2532, d) Manila 02731, e) Manila 2731, f) Manila 01618, g) Manila 01802, h) Manila 02419

¶1. (SBU) Summary: In 2008 the Philippines saw its growth rate fall, inflation jump, assets lose value and poverty increase, primarily as a result of global economic conditions. Nonetheless, the country continues to be reasonably well placed to weather the shocks which have so far occurred. With wealth and economic and political power highly concentrated, and relatively insulated from important aspects of globalization, the Philippines has some room to maneuver in a global downturn. The same features of the country's economy also mean that the Philippines will continue to under perform its neighbors once the world economy begins again to grow. The country's ossified economic structure has resulted in desperate poverty for more than one third of Filipinos. U.S. policy and assistance have been crucial for those few economic reforms which have been implemented and our subtle help and prodding will continue to be important to helping the country take advantage of the opportunities which the continuing process of globalization will afford it. End Summary.

2008 Buffeted, But Buffered

¶2. (SBU) The past year was challenging for Philippine policy makers. Coming off a spectacular (for the Philippines) 2007 growth rate of 7.2% to about 4% was tough enough. Worse, the unprecedented price increases, especially in the principal foodstuff of the country, rice, threatened to leave much of the population increasingly hungry. Unfortunately, the government itself reacted with panic and government actions in the international rice market are believed by many analysts to have driven prices even higher.

¶3. (U) Considering the unfavorable external shocks of the past year, the Philippines has done relatively well. Export growth, although still up somewhat (1.8%) during the first ten months of the year, contracted sharply (14.9%) in October, its worst performance in seven years. Accounting for about two-thirds of annual export revenues, electronics exports were down nearly 4% over the first ten months of the year, with exports in October logging a sharp 18.9% year-on-year drop. The uncertain global environment also pulled down foreign direct investment flows and triggered a withdrawal of foreign portfolio capital. As of September, net foreign direct investment had plunged by 46% year-on-year to $1.4 billion and net withdrawals of portfolio capital stood at $1.3 billion. The national income accounts show that investments in durable equipment, up 6% in real terms during the first half of 2008, slowed to no growth during the third quarter.

¶4. (U) The conservative nature of the Philippine banking sector, a drag on economic growth in good times, is now serving as a buffer against the financial crisis in the U.S. Banks are well capitalized

and relatively unexposed to foreign risk (ref a). Financial assets nonetheless, have taken a beating. As of mid-December, the stock market has lost some 48% of its value since end-2007, and the peso fell nearly 17% against the dollar.

¶5. (U) Job losses so far may be counterbalanced by the continuing announcements of major new hiring in the business process outsourcing sector. However, poverty worsened over the past year, especially because of the food price shocks of 2008. The latest official poverty statistics for 2006, released in early 2008, estimated that poverty rose from 30% of the population in 2003 to 33% -- equivalent to 3.8 million more poor Filipinos (ref a). Although official poverty estimates are conducted only every three years, our rough estimate using a recent World Bank impact analysis of food inflation is that the Philippine poverty rate may have increased by another 3 percentage points between 2006 and 2008 (equivalent to roughly 5 million more Filipinos joining the ranks of the poor).

2009: Slow But Steady

¶6. (U) The hallmark economic reform of the Arroyo administration, the 2005 increases in, and broadening of, the value added tax, has been the key to the recent economic stability of the country and is crucial to the ability of the government to remain afloat as the economy slows and private debt financing becomes difficult or impossible to obtain. Most analysts believe that the remittances of overseas workers, up by more than 17% as of September 2008, will continue to grow, albeit slowly, over the next year. In 2009, increased public sector expenditures and remittances should allow both government and individuals to continue the consumption which is

the basis for Philippine economic stability. The government officially abandoned its goal to balance the budget in 2008, opting instead for deficits in 2008 and 2009.

¶7. (U) Growth will continue to slow -- to about 3% in 2009, while inflation also slips down to about 6%, per consensus forecasts, reflecting softer food and fuel prices. We expect that job growth will turn negative, with significant job losses in the electronics sector, slowing growth and the return of some overseas workers from abroad. The booming business process outsourcing sector will buck the trend, continuing to generate new jobs, and softening the employment impact of the slowdown. Nonetheless, with continued high population growth resulting in about a million new workers entering the labor force every year, we expect higher unemployment and further increases in poverty (ref b).

Fundamental Constraints to Growth and Development
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¶8. (U) Unfortunately, while the isolated and underdeveloped nature of the Philippine economy results in relative stability in the current global economic turmoil, it is also a key reason why this country has gone from being one of the richest in Asia in the 1950s to one of the poorest, today. By almost any measure, the Philippines has consistently failed to provide a competitive investment climate and, as a result, has slipped further behind its neighbors in a famously dynamic region of the world.

¶9. (U) The Philippines has tremendous economic potential. Sitting at the epicenter of marine biodiversity, it has fisheries potential. The ninth most mineralized country in the world, it has tremendous, mostly untapped, mineral wealth. Mindanao and parts of Luzon have important agricultural resources. With uncounted miles of beautiful white sand beaches, many of them sitting on tranquil protected seas, the country boasts great tourism possibilities. Finally, though the education system has deteriorated over the 62 years since independence, the country still boasts a relatively well-educated, English-speaking, hard working and service oriented population. Most U.S. investors here tell us that the number one attraction of the Philippines is the workforce. Nonetheless, more than 45% of the population subsists below the $2 a day international poverty benchmark. The great challenge of the Philippines is to unleash its

potential and thus create opportunities for all of its population.

¶10. (U) A 2008 Policy Research Working Paper of the World Bank (#4472, Rising Growth, Declining Investment: The Puzzle of the Philippines, available at http://go.worldbank.org/NQQO5TWHR0) describes the Philippine problem quite well. The Philippines has consistently attracted far less investment, both foreign and domestic, than almost any other country in the region. While a number of factors are involved, one stands out. Investment is low in the country as a result of elite capture of the levers of government and oligopoly in key sectors of the economy. With government assistance, elite monopolies and oligopolies provide key inputs (transportation and cement, for example) at prices which make other sectors of the economy less competitive and less attractive for investment than they otherwise would be. Economic growth is maintained at a level which has been politically sustainable (and has sustained elite profits) via emigration of workers and creation of export-oriented industries which operate mostly outside of the domestic economy.

¶11. (U) Economic researchers identify the weak Philippine state as a key aspect of the problem. Heavily controlled by and dependent upon the elite, government has been unable to increase tax effort above 17%, a historic peak achieved in 1997 which lags most countries in the region. Tax effort has since fallen back to about 14% in 2008. As a result, public infrastructure, public education and health care have also been chronically under funded, resulting in the degradation of what was one of the best education systems in Asia and extremely poor infrastructure in an archipelagic and mountainous country in which transportation infrastructure is of critical importance.

¶12. (SBU) Unsurprisingly, government investment has been particularly low in the more remote and distant reaches of the country. Nowhere is investment in infrastructure, education, and health care more lacking than in the conflict-affected areas of Mindanao, populated by a Muslim majority. For example, while some 70% of students nationwide complete their primary education, only 30% of students in the Autonomous Region of Muslim Mindanao accomplish that goal.

Overcoming Constraints with U.S. Assistance

¶13. (SBU) In this environment, achieving real reform is a daunting task, and yet meaningful reforms have taken place, primarily by building strong connections to pro-reform constituencies. The USG has played an important, though unheralded, role in these reforms. (Note: The USG role in many of these reform initiatives is very discreet. Nationalist reactions can reduce or eliminate our effectiveness. Please protect information on the USG role in initiatives as noted in SBU paragraphs below.)

Energy

¶14. (SBU) In 2001, Congress enacted the Electric Power Industry Reform Act, which had been drafted with substantial technical assistance from USAID. Under the Act, and with continuing USAID assistance, the government has established an electricity wholesale market which is viewed as a model around the world. Some 72% of state-owned generating assets have been privatized, as has the electric grid. The government is now on the verge of establishing "open access," to allow large consumers of energy to contract directly with producers. Reform of this sector has the potential to substantially reduce currently high electric costs, a key constraint to growth (ref c). Likewise, USAID provided technical assistance in the drafting of new region-leading legislation on alternative fuels in 2007 and renewable energy in 2008 (ref d). With our assistance, coalitions of energy users have formed and been able to negotiate with the monopoly distribution company reductions in rates of as much as 10%.

Civil Aviation

¶15. (SBU) After supporting a new legal and regulatory framework for liberalized aviation, USAID continued to work with a broad coalition of economic interests centered on the Diosdado Macapagal International Airport at the former Clark Airbase to win new, liberalized air service agreements with numerous countries including South Korea, Macau, Hong Kong, Thailand, Malaysia, and Japan (ref e).

¶16. (SBU) Improved air transport through the Clark Airport has led to a more competitive market and many more flights--at cheaper rates--for tourists, business travelers, and Filipinos traveling to work overseas. As a result, passenger arrivals to the Diosdado Macapagal International Airport at Clark have increased ten-fold since 2004, and the airport is fast emerging as an alternative to the congested airport in Manila. More importantly, this activity broadens the base of constituents supporting liberalized air travel and transportation nationwide and supports the dynamic development taking place outside of Metro Manila. We are now working to identify the potential for similar coalitions to lobby for more liberal policies for airports in Cebu, Davao, and other major destinations.

Maritime Shipping

¶17. (SBU) Maritime shipping suffers from oligopoly pricing which is actually supported by current legislation. Understanding that a direct attack on that legislation would be unsuccessful, USAID pushed instead a scheme for roll-on, roll-off transport in which land transportation was supplemented by a network of ferry ports allowing land/ferry transportation between almost any two points in the Philippines. As a result, domestic shipping costs are estimated to have fallen by nearly 45% on key routes while allowing smaller scale producers to participate in inter-island commerce for the first time (ref f). We are simultaneously working on increasing competition in port services. In an archipelagic nation such as the Philippines, increasing efficiency in domestic shipping is crucial.

Infrastructure

¶18. USAID assistance supported a high-level, inter-agency infrastructure monitoring task force to analyze and address the range of legal, logistic, and financing issues impeding the timely implementation of high-priority infrastructure projects. In less than two years this group became instrumental in resolving many long-standing project implementation issues, leading to the successful completion of dozens of projects including toll roads, airports and sea ports, collectively worth more than $1.5 billion. Acting directly to deal with the lack of publicly-funded infrastructure in one of the poorest regions of the country, USAID has invested $59.8 millionover the past5 years in infrastructure in Mindanao.

Banking and Finance

¶19. (SBU) USAID technical assistance to the Rural Banking Association has been crucial to helping rural banks become efficient lenders to micro-enterprise. From practically nothing a decade ago, there are now hundreds of rural banks participating in microlending. They have made some 1.5 million loans over the last ten years, totaling about $325 million, to almost half a million borrowers. The program is growing rapidly, with about a third of the lending taking place over the past two years. In 2008 the Philippine Congress passed two pieces of legislation which were the result of USAID technical support and which have the potential to make major contributions to development. The Personal Equity Retirement Account Act creates a framework for private retirement savings, much like the U.S. 401K system. The Credit Information System Act creates a system for exchange of credit information, much like credit bureaus, to make lending more secure and credit more available.

Investment

¶20. (SBU) Econ, USAID, FCS and FAS are all involved in our interagency efforts to protect U.S. investment here and improve the Philippine investment climate. Substantial restrictions on foreign investment are written into the Philippine Constitution and laws. The effort to raise the profile of these investment restrictions and build support for their elimination seems to have gained steam this year, and the issue has come into mainstream discussion over the past few months. While complicated domestic politics makes a revision of these provisions unlikely in the short term, we will continue to press the issue as it will benefit U.S. investors and, by bringing outside competition into the domestic market, also holds great potential to increase competition in the domestic market and increase the competitiveness of the economy as a whole.

Trade

¶21. (SBU) Likewise, freer trade has the potential to increase competition and thus help to overcome the key constraints on the domestic economy. In 2008 the Philippines completed ratification of its first bilateral free trade agreement. The Japanese- Philippine Economic Partnership Agreement is quite limited in scope and potential and was a challenge for the government to negotiate and ratify (ref h). Nonetheless, it represents important progress. We continue to work on preparing the Philippines, both economically and politically, for eventual free trade with the U.S.

Comment: An Important Economic Partner Facing Challenges
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¶22. (U) The Philippines remains an important market, particularly for U.S. agriculture. It has the potential to be an even more important market. However, breaking down the anti-competitive structures of this market takes time and imagination. Our investment thus far has been substantial and has led to important reforms. We expect that to continue.

Kenney